not called into question the Judge's finding that an account-specific FLC would be impracticably cumbersome to compute, suggesting that if the exercise were as easy as the CLEC Coalition contends, the CLEC Coalition could have performed it in its brief on exceptions, thereby permitting Verizon to respond to the analysis.

The CLECs have not shown the FLC to be unnecessary for its stated purpose; at most their arguments imply that it should have been applied in Phase 1 as well. That it was not applied there does not preclude its use here, for it appears to be a proper methodological refinement. (Methodological refinement, of course, can raise rates as well as lower them; the test is whether the adjustment makes sense.) The general exceptions to the FLC accordingly are denied, and we reject as well the CLEC Coalition's proposal to calculate an FLC on an account-specific basis; the Judge properly found any such effort to be impracticable. That said, we reiterate the Judge's observation that "use of the FLC to avoid double counting the effects of TELRIC requires being sure that the remaining 'single count' is not understated. To that end, expense adjustments should be rigorously applied where warranted."[104] We have taken account of that recommendation in our decisions.

We have recalculated the FLC on the basis of our determinations today; the restated figure is 65%.

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[104] R.D., pp. 43-44.

Removal of Retail Avoided Costs

Consistent with the premise of the FCC's UNE pricing regulations, Verizon's studies reflected the assumption that Verizon was a purely wholesale company; they sought, therefore, to remove avoidable retail costs from consideration. AT&T argued that Verizon had not gone far enough in that direction and that, among other things, it should have excluded Universal Service Fund (USF) contributions, which are assessed on the basis of retail end-user revenues and accordingly would not be incurred in a wholesale-only environment. Verizon responded that the hypothetical wholesale-only environment would likely involve changes in the USF and that it was unlikely that Verizon and other ILECs would be relieved of all responsibility for universal service. More fundamentally, Verizon pointed to the Eighth Circuit's rejection of the wholesale-only premise that underlies exclusion of USF expenses, arguing that that aspect of the court's decision had not been stayed pending Supreme Court review and that we therefore were obligated to take it into account.[105]

The Judge adopted Verizon's retail adjustment as a placeholder, noting that AT&T had not addressed itself to the effect of the Eighth Circuit's decision on its USF adjustment and that Verizon had not presented any estimate of how the decision would affect its own figures. He noted as well that the Eighth Circuit's decision on this matter "pertained to resale rates, not UNEs. Extending it to the calculation of excluded retail costs for purposes of UNE pricing may have the benefits of consistency, but the CLEC Alliance [which had raised the issue before the Judge but did not file a brief on exceptions] presents arguments, on which judgement can here be reserved, against doing so."[106] The Judge accordingly invited further consideration of this issue.

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[105] More specifically, the Eighth Circuit determined that the 1996 Act called only for removal of retail "costs that are actually avoided," a lesser amount than the "avoidable" retail costs that the FCC required be removed.

[106] R.D., p. 44, n. 97.

On exceptions, AT&T asserts that the TELRIC standard remains in place pending Supreme Court review of the Eighth Circuit decision and urges us to "simply ignore the most recent Eighth Circuit decision in [our] decision on all issues raised in this docket."[107] It sees no reason to single out retail avoided costs for special treatment, noting, as did the Judge, that the portion of the Eighth Circuit's decision at issue pertained to resale rates, not UNE prices.

Verizon, in contrast, contends it would be irresponsible to ignore the Eighth Circuit decision, which, though directed specifically to resale rates, is equally applicable to UNE pricing. It cites in this regard our statement in Phase 1 that there was no basis for distinguishing between resale rates and UNE prices for purposes of estimating the retail costs to be excluded[108] and that the Eighth Circuit decision accordingly is directly applicable. With specific reference to the Universal Service Fund matter, Verizon argues that the Eighth Circuit decision removes the entire premise for AT&T's adjustment, and it reiterates its argument that even without the Eighth Circuit decision, it would be unreasonable to assume that Verizon would have no USF responsibilities in a wholesale-only environment. Finally, responding to the Judge's invitation, it submits a recalculation of its avoided costs computed in a manner it sees as consistent with the Eighth Circuit decision and estimates that the adjustment would thereby be reduced by approximately $175 million.

In its reply brief on exceptions, AT&T argues that the Eighth Circuit, in a portion of its decision not previously cited in this case, explicitly ruled that Universal Service Fund costs should be excluded from the costs of providing network elements inasmuch as they are not based on actual costs.[109] The

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107 AT&T's Brief on Exceptions, p. 31.

108 Phase 1 Opinion, p. 96. It is noteworthy that in Phase 1, Verizon advocated a distinction here while AT&T opposed it.

109 AT&T's Reply Brief on Exceptions, p. 84, citing Iowa Utilities Board v. FCC, 219 F. 3rd 744, 753.

Eighth Circuit accordingly did not remove the basis for AT&T's adjustment, as Verizon suggests; rather, says AT&T, it affirmed it. Verizon asks, in its post-briefing motion, that this portion of AT&T's reply brief be disregarded, inasmuch as AT&T had not raised the argument in its initial brief, where it contended only that the Eighth Circuit decision was irrelevant here. Should we deny that request, Verizon would respond that the Eighth Circuit was dealing with above-cost contributions to the USF, which Verizon agrees should not be recovered in rates and which it has not sought to recover. The point here, it says, is whether they should be again be removed in calculating retail avoided costs. Finally, AT&T objects as well to Verizon's recalculation of avoided costs, characterizing it as a "completely extra-record improper submission of what purports to be a recalculation of Verizon's entire avoided cost study."[110] It urges that the recalculation be disregarded. Verizon responds that the recalculation was requested by the Judge.

Turning first to the procedural issue, AT&T's argument with respect to the Eighth Circuit's treatment of the USF should have been raised on exceptions, in response to the Judge's request to brief the issue. But in the interest of full consideration, we will entertain Verizon's response rather than striking the passage in AT&T's brief.

Taking account of all the arguments before us, we reject AT&T's USF adjustment as unsupported and unnecessary, if only because Verizon has already removed USF contribution from its calculations. But we also see no need to modify the retail avoided cost adjustment further in light of the Eighth Circuit, inasmuch as the portion of the decision not stayed relates to resale rather than UNEs, and a TELRIC-based decision on UNEs should continue to reflect avoidable, rather than only avoided, retail costs.

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[110] AT&T's Reply Brief on Exceptions, p. 84.

ACF Versus CCF

Verizon's ACF method, in contrast to the CCF mechanism used in the First Elements Proceeding, assigns some costs and expenses not on the basis of investment but on the basis of expenses or revenues. As a result, a portion of the common overhead ACF is assigned to non-recurring charges which, because they entail no investment, would bear no assignment of common overhead under the CCF method. The CLEC Coalition objected to this change, urging continued use of CCFs in order to avoid what it regarded as an unwarranted increase in non-recurring charges. The Judge agreed with Verizon, however, that non-recurring charges should bear a portion of the overhead costs from which they benefit, and he therefore found the ACF method for allocating costs to be reasonable.

The CLEC Coalition excepts, asserting that because common overhead costs are incurred on a recurring basis, they should not be recovered through nonrecurring charges. In addition, it contends that we have required use of CCFs in the context of collocation rates and that the applicable FCC rules require that UNE and collocation rates be calculated on the same basis. It contends further that approval of the ACF method will entail a departure, without adequate explanation, from the UNE pricing method adopted in Phase 1 of the First Proceeding.

In response, Verizon cites testimony that the existence of nonrecurring activities has a direct effect on the level of these expenses.[111] It argues further that the FCC regulations cited by the CLEC Coalition require only that both UNE rates and collocation rates be set on a TELRIC basis and do not require that the TELRIC standard be applied in the same manner to different groups of rates. In any event, Verizon adds, it has been recognized throughout the proceeding that the factors ultimately adopted in this module would apply to collocation rates as well as to UNE rates.

Verizon's response is persuasive, and the exception is denied.

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[111] Tr. 3,313.

Network ACF

The network ACF "includes repair, rearrangement and testing expenses as well as testing equipment capital costs, plus plant account and general network loadings."[112] In calculating the factor, Verizon assumed a reduction in "R dollars," the costs associated with subscriber troubles, on the premise that such troubles would diminish with the placement of newer copper plant. It did not reduce "M dollars," attributable to rearrangements associated with customer moves, municipal requirements, and network upgrades, seeing no basis for assuming that such costs would decline.

The Judge held that Verizon had failed to refute the reasonable expectation that moves and rearrangements would be less costly in a forward-looking system. He cited, in this regard, a statement by Staff in its scoping memorandum prepared early in the proceeding as well as a press release by SBC (another regional Bell operating company) stating that new loop infrastructure "will substantially reduce the need to rearrange outside plant facilities when installing new or additional services."[113] He regarded WorldCom's 50% adjustment to M dollars as unduly high, however, and recommended a 30% adjustment unless parties could show on exceptions that a different figure was warranted.

Verizon excepts, contending that despite Staff's statement in the scoping memo, Verizon's witness had shown in uncontroverted testimony that there was no technology that would permit reductions from historical levels of M dollars. It objects as well to reliance on the SBC press release, arguing that WorldCom had offered no testimony on how it was relevant and that Verizon's witnesses had shown, among other things, that projected savings such as these might not emerge. Verizon regards it as unreasonable to reject the expert testimony of its witnesses in favor of a press release discussing another company's network, insisting there is no record basis to assume

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112 Verizon's Initial Brief, p. 54.

113 Exhibit 393 (offered by WorldCom), p. 7.

that SBC's network is consistent with the one contemplated by Verizon's studies. Verizon particularly objects to application of the 30% adjustment to the pole and conduit accounts, which encompass items whose cost will not decline as a result of technological advances.

AT&T responds that Verizon's exception merely reiterates its conclusory testimony, regarded as inadequate by the Judge, that network reconfiguration will continue to be required even in a forward-looking network. According to AT&T, Verizon fails to respond to the Judge's observation that Verizon had not recognized the extent to which those activities might be less costly then they had been in the past. AT&T charges that Verizon's discussion of Exhibit 393 does not address the Judge's fundamental concern that Verizon had not borne its burden of proof, and it notes that Verizon likewise failed to consider whether the 30% adjustment recommended by the Judge should be replaced by some other number, insisting only that no adjustment at all would be proper. AT&T specifically disputes, as lacking any record basis, Verizon's proposal to treat poles and conduits differently.

Possible differences between SBC's network and Verizon's might well preclude reliance on SBC's experience for purposes of estimating the amount of an adjustment, but the Judge did not use the SBC statement for that purpose. Rather, he saw it as confirming the reasonable inference, already reflected in the Staff scoping memorandum, that even though forward-looking technology would not obviate network reconfiguration, it would reduce its cost. Despite its burden of proof, Verizon's effort to refute that premise pertained to the continued need for reconfiguration, which the Judge acknowledged, but not to its cost; and the Judge reasonably found that an adjustment was warranted. He conservatively regarded WorldCom's 50% adjustment as excessive and adopted a 30% figure instead, and Verizon's exception, limited to the adjustment in principle, offers no basis for any other number. Verizon does, however, provide a qualitatively persuasive basis for not applying the adjustment to pole and conduit accounts, where there are less likely to be technological advances that reduce costs. Verizon's exception is granted to the extent that the adjustment will not be applied to poles and conduits; it is otherwise denied.

In a separate matter under this heading, WorldCom contended that the Network ACF was overstated because of a diminution in the adjustment--the copper repair adjustment factor (CRAF)--designed to eliminate recovery of expenses associated with repairing deteriorated copper plant. In the First Proceeding, the "deteriorated copper repair reduction," an important portion of the CRAF, had been set at 60%; Verizon here proposed to lower it to 35%, thereby reducing the overall CRAF from 42% to 25%. The 35% deteriorated copper repair reduction results from averaging the 60% used in the First Proceeding on the basis of a 1996 study with a new estimate of 10%. WorldCom charged the new figure lacked evidentiary support and was simply an unexplained estimate; Verizon argued that its reduction to the CRAF reflected the notion that newer plant already in good condition was less likely to experience large trouble rate improvements in the future. The Judge found that argument to make sense in concept, but he regarded Verizon's 10% estimate to be inadequately supported. Verizon had associated that figure with units that would be experiencing excellent service, and the Judge saw no basis for assuming that all equipment would have as small an improvement as the best units. In the absence of a better estimate, and in view of Verizon's burden of proof, he substituted a 25% estimate for Verizon's 10% and averaged that 25% figure with the 60% of the First Proceeding.

Verizon excepts, arguing that no party had offered testimony challenging its 10% figure and that cross-examination of its witness, who had directly pertinent expertise, reinforced its reasonableness.[114] It denies it failed to meet its burden of proof, arguing that if the 25% figure used by the Judge had been submitted in responsive testimony, Verizon could have offered rebuttal. It recognizes that its 10% figure is based on part on

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[114] Tr. 5,272-5,287.

judgment, but it argues that the judgment "reflects the expert opinion of a witness with years of relevant experience who was willing to face cross-examination to test the reasonableness of the exercise of his judgement," and that there is nothing in the record to challenge that judgment.[115]

In response, AT&T maintains the record provides a basis for questioning the 10% figure and contends that evidence and argument submitted by several CLECs and cited by the Judge support the Judge's conclusion.[116] It asserts that Verizon's effort to pretend the evidence is not there does not make the evidence disappear, and that the weight to be assigned to the evidence is a matter to be determined by the Judge and, ultimately, by us.

The record on this issue is not so conclusive as either side would have it. The pages of the recommended decision referred to in AT&T's reply brief on exceptions relate in large part to matters other than the specific CRAF adjustment; but the pages of the transcript cited by Verizon do not sustain its 10% figure against the criticism that a number associated with the best performing equipment should not be universally imputed. The Judge reasonably took account of that unrefuted concern in making a conservative adjustment to Verizon's figure, and Verizon's exception is denied.

Wholesale Marketing ACF

The wholesale marketing ACF captures the expenses of "advertising, product management, and customer interfacing functions."[117] Verizon claimed to be seeking recovery here only of the costs that would be incurred in a wholesale market, but nevertheless included certain advertising expenses. Several CLECs objected, contending that there would be no need to advertise the availability of UNEs at wholesale and that

115 Verizon's Brief on Exceptions, p. 69.

116 AT&T's Reply Brief on Exceptions, pp. 78-80, citing R.D., pp. 46-48.

117 Verizon's Initial Brief, p. 59.

allowing advertising expense would require CLECs to pay twice for advertising--once to Verizon and once through their own advertising channels. The Judge disallowed 85% of the claimed advertising expense, noting that we had disallowed 90% in the First Elements Proceeding but that evidence on this record suggested that some wholesale advertising was now under way and warranted a reduction in the disallowance.

Verizon excepts, contending, as already discussed, that the Eighth Circuit decision precludes assuming a wholesale-only environment. In a mixed wholesale/retail TELRIC environment, Verizon continues, it would be doing the same sort of advertising it does today and, accordingly, no disallowance should be applied. Beyond that, Verizon reiterates its arguments that even in a wholesale-only environment, it would engage in market stimulation advertising, brand awareness advertising, and advertising to the CLECs themselves.

AT&T responds that Verizon is merely reiterating the arguments on advertising that the Judge found unpersuasive. It sees no record basis for Verizon's claim that as a retail/wholesale provider in a TELRIC environment it would be doing the same sort of advertising it does today. (AT&T's more general arguments on the wholesale-only issue have already been noted.)

As already explained, the Eighth Circuit's decision with respect to resale rates, though not stayed, does not require changing the assumptions applicable to UNEs. Verizon has shown no basis for departing in principle from the decision we made in the First Proceeding, and the Judge adequately tempered that result by reducing the amount of the disallowance in on the basis of evidence presented here. Verizon's exception is denied.

Common Overhead ACF

"The common overhead ACF reflects common overhead expense, SPE or equivalent expenses[,] and savings from the Bell Atlantic/NYNEX Merger."[118] Exceptions are raised with regard to all three components.

1. Common Overhead Expenses

Common overhead expenses are those associated with activities, previously designated as general and administration (G&A) functions, including executive, planning, general accounting and finance, external relations, legal, and human relations. The recommended decision disallowed certain expenses related to Y2K concerns, rejecting as unproven Verizon's argument that the incurrence of those costs merely served to defer other costs and that no disallowance accordingly was warranted.

Verizon excepts, contending that the only relevant evidence was offered by its witness, who had day-to-day familiarity with the pertinent budgets and testified that the Y2K costs only deferred the incurrence of others. AT&T responds that the Judge properly found that Verizon failed to prove its case, inasmuch as Verizon had "offered no analysis or quantification to support its witness's creative assertion" and that "the fact that Verizon's witness asserted a proposition does not mean that the finder of facts has no choice but to accept that proposition."[119]

Verizon's argument on exceptions simply refers to its witness's testimony, which the Judge found inadequate. Y2K costs are inherently a one-time event, and Verizon has not disproven the reasonable premise that they should be disallowed as such. Its exception is denied.

[118] Verizon's Initial Brief, p. 63.

[119] AT&T's Reply Brief on Exceptions, p. 69

2. Special Pension Enhancement Expense

Special Pension Enhancement expenses are those associated with Verizon's offering of enhanced retirement benefits in order to reduce its workforce. In Phase 3 of the First Proceeding, we denied Verizon's request to recover some $387 million of such costs. We cited procedural grounds, related to the timeliness of the claim, and substantive grounds, including, among other things, the need to recognize possible offsetting savings. We nevertheless authorized renewed consideration of the issue in this proceeding, albeit it on a prospective basis only; and we added, in response to AT&T's request for rehearing, that Verizon bears the burden of showing any allowance to be procedurally and substantively proper.[120] In the present proceeding, Verizon seeks to recover some $400 million of SPE, a figure based on the average of 1998-1999 SPE expenses, adjusted to remove avoidable retail costs. It contends, in essence, that the productivity reflected in its cost studies can be achieved only if it continues to restructure its workforce in a manner requiring the expenditure of SPE costs.

Various CLECs argued, among other things, that these costs are incurred to overcome the effects of past inefficiencies, that they would not be incurred by an efficient forward-looking company, and that allowing them would contravene TELRIC. The Judge agreed with Verizon that early retirement incentive costs could be incurred in a TELRIC environment and held that the costs to be allowed here, if any, "should reflect the normal level of costs that Verizon could be expected to incur in that environment."[121] He found, however, that Verizon had not borne its burden of proving that its claimed $400 million of costs would be incurred in a forward-looking environment; that there was no basis on the record for

[120] Phase 3 Opinion, pp. 21-22; Phase 3 Rehearing Opinion, pp. 6-7. A full discussion of the issue's background appears in the Phase 3 Recommended Decision (issued October 2, 1998), pp. 18-20.

[121] R.D., p. 59.

identifying some lower amount; and that recovery of SPE expenses should again be disallowed. In reaching that conclusion, he cited evidence[122] that there had been considerable variation in annual SPE costs between 1994 and 1999, calling into question Verizon's reliance, in forming its estimate, on the costs incurred in 1998 and 1999, the second and third highest of the six years. He noted as well that the six years encompass two mergers, which could be expected to involve unusual levels of early retirement, and the transition from monopoly to competition, which could also be expected to involve an unusual degree of workforce reduction. Finally, he noted again that allowance of the FLC adjustment requires special diligence to be sure that all forward-looking expense reductions are properly reflected.[123]

Verizon excepts, disputing the premise that these are transitional costs incurred to move to a properly sized workforce and asserting that such costs are incurred by all businesses needing to restructure or refocus their workforces in a manner that may involve reductions in some areas and increases in others. It notes that its workforce overall was not substantially reduced between 1995 and 1999 and that nonmanagement workforce actually grew in order to meet the company's service related commitments. More specifically, it notes that one of the two mergers referred to by the Judge was not completed until 2000, after the period analyzed, and that AT&T itself, a company that has not experienced major mergers and not been subject to rate of return regulation, has also incurred SPE costs in recent years.[124] Finally, Verizon contends that to recognize an assumed level of productivity and merger savings without allowing the costs that must be incurred to realize those savings "is analogous to adopting rates that

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[122] Exhibit 410,CC-VZ-154 (revised supplemental response).

[123] R.D., pp. 59-60.

[124] Tr. 3,058.

reflect cost savings from a change in technology, while ignoring the costs of developing that technology."[125]

In response, AT&T reviews the history of the issue and supports the Judge's rejection of what it characterizes as Verizon's "by now threadbare arguments."[126] It contends that Verizon has failed to demonstrate why it will continue to need workforce refocusing in the future and why its 1994-1999 experience provides a reliable basis for projecting the future. It notes that the 1994-1999 period included movement from cost-of-service regulation to incentive regulation, substantial corporate restructuring (including a significant merger), and the transition to dealing with at least limited competition. The CLEC Coalition likewise objects to any allowance, noting, among other things, Verizon's failure of proof.

Verizon's exception, like its argument to the Judge, makes a good case for the proposition that SPE costs should not be viewed entirely as a transitional matter and that they are likely to be incurred in some amount on an on-going basis. But the exception, again like the argument to the Judge, fails to provide any basis for estimating that on-going cost. The historical years studied by the company involved major changes in its operations and organization, and even if, as Verizon argues, its overall workforce did not decline, there is certainly reason to assume an atypically high degree of "refocusing."

As the party with the burden of proof, Verizon should have done more to parse its historical experience into its normal and non-normal components; and its failure to do so, together with the need, already noted, to review these expenses rigorously because of our approval of the FLC, could justify continued total disallowance of the item, as the Judge recommends. But burden of proof, for all its importance, is ultimately a device to be used for the purpose of setting of just and reasonable rates, and to disallow all SPE costs here on

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125 Verizon's Brief on Exceptions, p. 65.

126 AT&T's Reply Brief on Exceptions, p. 70.

burden of proof grounds would be to reach a result that was procedurally justified but substantively wrong. In the absence of a better estimate, we will allow $60 million of SPE costs, representing 75% of a five-year average of those costs in the early 1990s, before the advent of the mergers and competitive markets that tend to increase these expenses.[127] In doing so, we recognize the qualitative reality that these costs will not disappear in a TELRIC environment, but we keep the allowed amount properly low in view of Verizon's failure to prove a higher amount warranted.

3. Merger Savings

Verizon reflected, in its common overhead ACF, the savings associated with the NYNEX/Bell Atlantic merger but contended that the further savings associated with the Bell Atlantic/GTE merger could not yet be estimated. The Judge saw no doubt that an estimate of savings associated with the Bell Atlantic/GTE merger should be reflected, and he instructed Verizon to include an estimate of those savings in its Brief on Exceptions, which would follow the date for Verizon's submission on the matter in Case 00-C-1945, where the savings are being addressed. He invited all parties to comment on how to reflect those savings, inasmuch as rates would likely be set here before the conclusion of Case 00-C-1945.

AT&T urges recognition here at a minimum of the estimated savings submitted by Verizon in Case 00-C-1945, suggesting that the amount ultimately calculated in that case will likely exceed Verizon's estimate and that reflecting that minimum amount in UNE rates should not await the outcome of the separate proceeding. It would provide for further adjustment in UNE rates when Case 00-C-1945 is completed. In its reply brief on exceptions, AT&T questions two aspects of Verizon's estimate of the merger savings--its offsetting of projected 2003 merger savings by removing projected savings for 2001 and its removal of procurement expense savings and sales and marketing savings.

[127] See Resale Opinion, p. 59.

Verizon objects to any separate recognition of the Bell Atlantic/GTE merger savings, contending that their achievement is already reflected in its productivity adjustment, which the recommended decision has already increased. It insists that "realizing cost savings from mergers is one of the primary ways that companies can increase their productivity."[128] The CLEC Coalition responds that Verizon's productivity data predate the Bell Atlantic/GTE merger and that separate adjustments would not overlap.

We agree with the Judge that savings associated with the Bell Atlantic/GTE merger should be reflected here, and there is no basis for finding that they are already subsumed in Verizon's productivity adjustment.[129] Verizon's estimate of those savings (and its estimate of savings attributable to the NYNEX/Bell Atlantic merger) are being examined in Case 00-C-1945, and we should not here prejudge the outcome of that case. Accordingly, we adopt Verizon's savings estimates as placeholders and will set UNE rates on that basis; those rates should be adjusted prospectively at the conclusion of Case 00-C-1945 to reflect its results.

Depreciation ACF

In Phase 1 of the First Proceeding, we determined that the depreciation lives to be used in estimating UNE costs should be those set for Verizon consistent with the FCC's triennial represcription process; in so doing, we rejected Verizon's request to use shorter depreciation lives (and consequently higher expense) based on generally accepted accounting principles (GAAP). Consistent with that determination, Staff stated, as part of its effort early on to assist the parties in setting the scope of this proceeding, that

> the Commission decided in [the First Elements Proceeding] that TELRIC depreciation rates should be based on depreciation lives used in calculating

[128] Verizon's Reply Brief on Exceptions, p. 40.

[129] As noted above, we are granting Verizon's exception with respect to the amount of the general productivity adjustment.

> booked depreciation on a regulatory basis. If the service lives for [Verizon's] plant changed since rates were set in [the First Proceeding], the new service lives and depreciation rates should be used in developing TELRIC element costs.[130]

Claiming consistency with that precedent and guidance, Verizon proposed use of the depreciation lives we adopted for regulatory purposes effective January 1, 1998. The Judge, however, agreed with AT&T that rates should continue to be set on the basis of the longer service lives set by the FCC in 1995 and used in the First Proceeding. He found that the service lives we adopted in 1998 had been set pursuant to Verizon's Performance Regulatory Plan (PRP) and did not embody changes of the sort to be taken into account pursuant to Staff's August 1999 memo. He noted that Staff had expressed important reservations about those service lives, which Staff said it had reviewed only with respect to the benchmark established in the PRP; a full study conducted without the PRP's constraints might well have produced a different result. The Judge added that the 1998 changes predated Staff's August 1999 memo and that Staff, had it contemplated use of the 1998 changes here, could have said so. He regarded these considerations as outweighing Verizon's unsubstantiated concern that the 1995 depreciation rates had become stale.

On exceptions, Verizon contends that Staff was aware, when it stated in its memo that changed depreciation rates should be used in developing TELRIC costs, that the only mechanism for change was the one provided for in the PRP, and that Staff had determined, in the letter cited by the Judge, that the revised depreciation rates were consistent with the PRP guidelines. It suggests that Staff's reference to the different results that might be reached through a complete depreciation study was simply a "general reservation of differences, [providing] no basis for rejecting the use of regulated

[130] Staff memorandum dated August 11, 1999, quoted at Tr. 3,360 and in Verizon's Initial Brief, p. 69.

depreciation rates,"[131] and that no testimony had been offered, by Staff or anyone else, as to the specific concerns Staff was referring to. In contrast, it adds, Verizon offered a witness prepared to testify on its depreciation ACF.

In response, AT&T dismisses Verizon's exceptions as cursory and unresponsive to the Judge's reasoning. It renews its claim (on which the Judge did not rely) that its own depreciation witness was better qualified to testify on the subject than Verizon's witness.

In agreeing with AT&T that the 1995 depreciation lives should be used, the Judge overstated the significance for this proceeding of Staff's reservations about the 1998 lives. Service lives for Verizon's plant have, in fact, been changed since the First Elements Proceeding, and the fact that those changes were made in the manner contemplated by the PRP--something Staff would certainly have recognized when it provided the guidance in its scoping memo for this proceeding--is no reason to reject the use of those lives here. And though the special circumstances of the 1998 lives preclude reliance on them as precedent in any post-PRP consideration of depreciation, those shorter lives may well be appropriate for a TELRIC study, in that they better reflect the treatment of depreciation in the competitive market contemplated by TELRIC. Accordingly, Verizon's exception is granted.[132]

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[131] Verizon's Brief on Exceptions, p. 73.

[132] Verizon also asserts that the Staff calculations accompanying the recommended decision erroneously fail in some instances to use the recommended depreciation rates. There is no need, however, for any adjustment on that account. The depreciation ACFs calculated by Staff in fact differ in some instances from the Phase 1 depreciation CCFs, but that is not the result of a failure to use the proper depreciation rates. The difference results simply from insertion of the recommended service lives and salvage factors into Verizon's study for this proceeding, rather than its Phase 1 study.

COST OF CAPITAL

Introduction

Cost of capital presentations were made by Verizon and by AT&T jointly with WorldCom. Verizon proposed a figure of 12.6%, which it regarded as conservative in light of its study's conclusion that a forward-looking weighted average cost of capital related to the supplying of UNEs would be in the range of 13.03% to 13.38%. AT&T/WorldCom estimated the weighted average cost of capital to be in the range of 9.17% to 9.91%.

The parties differed little in their estimates of the cost of debt but disagreed sharply on cost of equity and capital structure. The differences reflected in part Verizon's view that it should be seen as a fully competitive enterprise subject to all the associated risks and entitled to a correspondingly higher return on investment and AT&T/WorldCom's contrary view that an incumbent local exchange company (and supplier of UNEs) remains an inherently less risky operation.

Verizon's witness calculated a cost of equity of 14.78%, based on a discounted cash flow (DCF) analysis of a proxy group comprising the companies included in the Standard and Poors (S&P) Industrials, and a debt cost of 7.77%. Verizon contemplated a debt/equity ratio in the range of 25%/75% to 20%/80%; the former implied an overall capital cost of 13.03%, while the latter implied 13.38%. In its studies, it used a figure of 12.6%, equal to the figure it uses in its own business decisions[133]; in light of its witness's calculations, it regarded that figure as conservative.

AT&T/WorldCom's witness calculated an equity cost of 10.42%, averaging the results of a DCF analysis of a proxy group comprising the regional Bell holding companies and the larger independent telephone companies (10.24%) and a capital asset pricing model(CAPM) analysis (10.6%). AT&T/WorldCom envisioned a capital structure ranging from 54% debt/46% equity to 20% debt/80% equity, implying an overall cost of capital (assuming a

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[133] Verizon's Reply Brief, p. 63.

debt cost of 7.86%) ranging from 9.17% to 9.91%; the midpoint of that range is 9.54%.[134]

In the First Proceeding, we adopted a weighted average overall cost of capital of 10.2%, reflecting a cost of equity of 12.1% and a debt/equity ratio of 40%/60%.[135] Relying in large part on our analysis in the First Proceeding, the Judge recommends an overall cost of capital of 10.5%, comprising a cost of equity of 12.19%, a cost of debt of 7.39%, and a debt/equity ratio of 35%/65%. Verizon and AT&T except, the former challenging several aspects of the Judge's analysis and the latter contending that the Judge's figure is at the high end of the range of reasonableness and that proper application of his own analysis would have produced a substantially lower number.

The Recommended Decision

Noting the continued pertinence of our discussion of the issue in the Phase 1 opinion,[136] the Judge first determined that AT&T's proxy group again reflected Verizon's risk profile better than did Verizon's proxy group, and he recommended its use. He reasoned that just as TELRIC should not be understood to contemplate "a fantasy network" that makes use of speculative technology, so, too, should it not "be taken to require basing the cost of capital on a 'fantasy marketplace,' in which the provision of local telephone service is as competitive as the sale of detergent."[137] While such a market is the goal, it has not yet been achieved with respect to local service and appears even more remote with respect to UNEs. To recognize the movement that has been achieved, however, he recommended use of

[134] Tr. 2,292, reflecting the updated estimates in rebuttal testimony, as slightly increased in a letter to the Judge from AT&T's counsel dated January 31, 2001.

[135] Phase 1 Opinion, p. 40.

[136] Phase 1 Opinion, pp. 38-39.

[137] R.D., pp. 76-77.

a capital structure of 35% debt/65% equity, rather than the 40%/60% structure we contemplated in Phase 1.

Next, again relying on the Phase 1 precedent, the Judge rejected Verizon's renewed request to recognize quarterly dividends and flotation costs in calculating the cost of capital. In Phase 1, we rejected those measures as "unnecessary and contrary to precedent," and the Judge saw no need to modify that result here.

Finally, the Judge noted that in the Phase 1 Opinion we rejected AT&T's proposal to use a multistage DCF model rather than the single-stage model advocated by Verizon, that AT&T's arguments in the present case resembled in many ways those in Phase 1, and that there continued to be no basis for rejecting the single-growth model and adopting a three-growth model as a matter of principle or theory.[138] He went on to suggest, however, that the unusual circumstances that had led us to use a multistage DCF model in a limited number of cases appeared to exist here as well and warranted some adjustment to the result produced by the single-stage DCF analysis. He considered a range of options, found their results to vary widely, and ultimately concluded that the best course of action was to calculate a cost of equity by applying, to the current cost of debt, the equity risk premium[139] that emerged in Phase 1. That risk premium came to 4.8 percentage points; applying it to the debt cost here of 7.39% produced a cost of equity of 12.19%, which the Judge found to be well within the range supportable by the record as a whole. Because Verizon challenges various aspects of the Judge's analysis, it is here set forth in full:

> Using the AT&T proxy group with updated data would suggest, under a one-growth DCF model, a return on equity of 14.77%--almost the same as the return Verizon calculated on the basis of its own proxy group. The

[138] R.D., p. 78.

[139] That is, the difference between the cost of debt and the cost of equity, reflecting the greater risk associated with equity.

figure comprises a dividend yield of 2.45% (measured as of March 30, 2001) and a growth rate of 12.32% (based on I/B/E/S growth rate as of March 15, 2001). Several factors suggest that result is unreliable and out-of-line, incorporating a growth rate that will not be sustained.

For one thing, the equity return calculated in the First Proceeding, 12.1%, exceeded the cost of debt calculated there (7.3%) by 4.8 percentage points. The present cost of debt (measured, as in Phase 1, as the average of Moody's composite rate for Aa rated debt and S&P's composite rate for A rated debt as of April 3, 2001) is 7.39%, and a 14.77 equity cost would exceed that figure by 7.38 percentage points. There is no explanation for so substantial an increase in equity risk premium, and it calls the calculated equity return seriously into question. Beyond that, there are several factors that could account for an extraordinarily high growth factor in the short run, among them the growth of wireless and data/internet and international services. These are unlikely to continue to sustain the growth factor in this way, and some remedial adjustment seems warranted.

Several alternatives present themselves. A three-growth DCF, applied to the AT&T proxy group, using the I/B/E/S growth rates for the first five years, an average of that growth rate and AT&T's alleged sustainable growth rate (6.29%) for the ensuing 15 years, and the sustainable growth rate thereafter produces an average equity cost of 10.30%. A two-stage analysis, using the sustainable rate after the first five years, produces an average cost of 9.26%. These figures appear unduly low, particularly when compared to a broadbased average calculated in the Merrill Lynch Quantitative Profiles analysis, using a three-stage growth model. The April 2001 edition of that document calculated a DCF return of 11.2% for both the S&P 500 and for a group of 29 telecommunications companies.

In view of these widely divergent estimates and the ongoing major changes in the industry that may account for them, it seems to me that a fair and conservative result can be obtained by applying to the current cost of debt the same equity risk

> premium that emerged in the First Proceeding. The cost of debt, as noted, is now 7.39%, and the equity risk premium in the First Proceeding was 4.8 percentage points. That suggests a cost of equity in this proceeding of 12.19%, a figure well within the range supportable by the record as a whole. The resulting overall cost of capital, using a debt/equity ratio of 35%/65%, comes to 10.5%.[140]

Exceptions

1. Verizon

Verizon contends the recommended cost of capital is unreasonably low, failing to reflect its risk in offering UNEs. Disputing the Judge's view that it would be wrong to contemplate vibrant competition in the offering of UNEs, it asserts that the FCC's Local Competition Order provides for UNE rates to approximate those that would be charged in a competitive market.[141] It argues that the increase in competition since issuance of the Phase 1 opinion and anticipated further increases justify the higher risk premium that troubled the Judge, and it charges that the recommended decision's "treatment of this issue is result-oriented, unbalanced, and ignores the record."[142] According to Verizon, the 14.77% cost of equity that resulted from application of a one-growth model to AT&T's proxy group was consistent with the results of its own witness's analyses, and the Judge's rejection of that result because of its high implicit risk premium conflicts with the requirement of the Local Competition Order that rates be set to simulate those that would prevail in a competitive market. Verizon alleges as well that the recommended decision fails to recognize risk factors other than competition such as operating leverage, the pace of technological change, and the regulatory environment. It stresses the last in particular, pointing to regulation's

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140 R.D., pp. 79-80.

141 Verizon's Brief on Exceptions, p. 74, citing Local Competition Order, ¶¶635, 679, and 738.

142 Verizon's Brief on Exceptions, p. 75.

imposition of large and thus far unrecovered investment in operational support systems and to the TELRIC construct, which requires rates well below actual costs.

Verizon disputes as well the Judge's treatment of capital structure, noting that it reflects only a relatively minor adjustment to the capital structure per Verizon's books, even though the Local Competition Order requires use of a market value capital structure which, according to Verizon, would contain more than 80% equity. It sees no basis for rejecting its witness's cost of capital analyses, some of which did not rely exclusively upon the S&P Industrials with their associated risk. It suggests several alternative figures to show the extent to which the Judge's 10.5% cost of capital is understated: using the recommended decision's proxy group and 11.8% cost of equity together with a 20%/80% debt/equity ratio produces a cost of capital of 11.23%; using Verizon's recommended capital structure and the 14.77% cost of equity that results from the recommended decision's single-stage DCF analysis produces a cost of capital of 13.3%; and using the recommended decision's capital structure with the 14.77% cost of equity produces a cost of capital of 12.20%.[143]

Finally, Verizon notes that the cost of capital used by AT&T in making its investment decisions is 15.31%, and that the 12.6% reflected in Verizon's studies is equal to the figure Verizon has used in making its own investment decisions.[144] Noting once again that its witness's analyses called for a cost of capital of 13.03% to 13.38%, Verizon reiterates its view that 12.6% would be a conservative estimate of the true cost.

AT&T disputes Verizon's criticisms of the recommended decision, noting that Verizon failed to mention the Merrill Lynch analysis that produced a cost of equity substantially lower than that recommended by Verizon's witness. More specifically, it charges that Verizon's claim of vibrant competition is unsupported by the record and cites our

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143 Verizon's Brief on Exceptions, pp. 78-79.

144 Id., p. 79, citing Tr. 2,892.

statement, in a recent opinion, that Verizon continued to dominate the special services market; it contends the same can be said with respect to the provision of UNEs.[145]

AT&T characterizes as "the most peculiar aspect of Verizon's argument" its discussion of regulatory environment, contending that Verizon "may not be awarded a higher cost of capital because it has failed to present a credible case for recovery of its alleged OSS development costs or because it would prefer to base UNE rates on its historical rather than its forward-looking costs."[146] Among other specific points, AT&T contends that the internal cost of capital rates that it used for its own planning purposes are of no relevance here. Referring to its own exception, next discussed, it contends that the Judge's recommendation is at the high end of the range of reason and should be reduced by at least 100 basis points.

2. AT&T

AT&T contends that the Judge failed to follow through on his conclusions, and that a proper application of his analysis would result in a weighted average cost of capital no higher than 9.19%.[147] It endorses the Judge's conclusions with regard to the state of competition in the UNE markets, the consequent propriety of using the proxy group advanced by AT&T, and the need to depart here from the single-growth model. It goes on to cite the great importance in the calculation, as evidenced from the Judge's figures, of the choice between a single-stage and multi-stage model and to agree that the single-stage growth figure would be unsustainable. Turning to the Merrill Lynch analysis cited by the Judge, which calculates a

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[145] AT&T's Reply Brief on Exceptions, p. 92, n. 42, citing Cases 00-C-2051 et al., Verizon New York, Inc. - Special Services, Opinion No. 01-1 (issued June 15, 2001).

[146] AT&T's Reply Brief on Exceptions, pp. 93-94.

[147] Verizon points out in response that the 9.19% figure appears to be an arithmetic error and should be 9.9%, given AT&T's statement that it represents the sum of 2.6% and 7.3%. (Verizon's Reply Brief on Exceptions, p. 41.)

DCF return of 11.2% for both the S&P 500 and a group of 29 communications companies, it contends that both of those groups are riskier on average than Verizon's UNE line of business. It therefore regards the study's 11.2% figure as a ceiling and excepts to the Judge's recommendation of a 12.19% cost of equity on the basis of his risk premium calculation. It urges reduction of the cost of equity to 11.2% and a resulting overall weighted average cost of capital of 9.19%.

Verizon responds that AT&T proposal here is unsupported by record evidence and is below the 9.54% cost of capital urged by its own witness. It disputes as well AT&T's claim that its figure is compelled by the Judge's reasoning, noting that the Judge relied on the Merrill Lynch analysis only as a basis for assessing the reasonableness of a multi-stage DCF. The analysis itself is not part of the record and played no role in the Judge's calculation of the recommended cost of capital. It argues again that its own 12.6% cost of capital is a conservative figure worthy of being adopted.

Discussion and Conclusion

The Judge for the most part followed the precedents we set in Phase 1, departing from them only when it appeared that the one-growth model produced an unreliable result incorporating an unsustainable growth and that the alternatives seemed no more reasonable. In view of the circumstances that appeared to account for the widely divergent results, he resorted to what amounts, essentially, to an update of the result we reached in Phase 1.

AT&T's exception provides no basis for reducing the result reached by the Judge in order to capture the "logical conclusion"[148] of his analysis; it simply calls for using some of the factors he took into account in a manner that suggests, through the application of AT&T's own judgment, a different figure. We are unpersuaded by that judgment, and AT&T's exception is denied.

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[148] AT&T's Brief on Exceptions, p. 18.